Internal Revenue Service
memorandum

CC:TL-N-3980-90
MLOsborne

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to: District Counsel, Austin CC:AUS
Attn: Jerry Hamilton

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

This is in response to your tax litigation advice request dated February 22, 1990, regarding the above-mentioned cases.

ISSUE

In an installment sale involving a $[redacted] exchange credit, where in a later year the exchange credit is fulfilled in part by like-kind property and in part by cash boot ($[redacted]), in what year is the boot included in income: the first year when the original transaction occurs, or the year that the boot is received?

CONCLUSION

The boot portion of the exchange credit of $[redacted] should be recognized in the year of receipt ([redacted]), rather than in the year the transaction occurred ([redacted]). Additionally, we believe the gross profit percentage should be adjusted in each year involved to reflect the modification resulting from receiving part of the $[redacted] exchange credit as cash. Accordingly, using your "Theories" as set out in your original request, we believe Theory 2 is the proper treatment of this transaction.

FACTS

In [redacted], [redacted] (seller/petitioners) purchased land for $[redacted]. Each owned a [redacted] percent interest in the property. This transactions and all others by the petitioners were entered into by them through one of their subchapter S corporations. In [redacted] they sold the property for $[redacted]. The $[redacted] was to be paid $[redacted] in cash, $[redacted] in notes due in [redacted], and $[redacted] in exchange credits. The petitioners were to utilize the exchange credits by identifying like-kind property in [redacted]. The buyer would then purchase this real estate with the exchange credits and transfer title to the petitioners. In [redacted] the petitioners identified one piece of like-kind property with a cost of $[redacted]. The buyer purchased and transferred title to the petitioners. The remaining $[redacted] in exchange credits were received by the petitioners in cash in [redacted].

ANALYSIS

Recognition of Boot

I.R.C. § 1031(a) provides, in effect, that no gain or loss shall be recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like-kind to be held for productive use in trade or business or for investment. Section 1031(b) requires that gain be reported to the extent of boot received. That is, the receipt of not like-kind property. In this case, since boot of at least $[redacted] was received, the gain of $[redacted] should be reported in some year or years. Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

Section 453 generally provides for installment method treatment for any sales where payment occurs in more than one tax year. Public Law 96-471 added section 453(f)(6), effective for transactions occurring after October 19, 1980. Section 453(f)(6) allows gain from a section 1031 exchange to be reported on the installment basis. In computing the contract price, section 453(f)(6) requires sales price to be reduced by the fair market value of section 1031 property received by the seller to the extent of the basis in section 1031 property given up by the seller. As noted in the Committee Report, "when like kind property and an installment obligation are received, the like kind property should not be treated as payment in order to achieve the basic purpose of installment sale reporting, i.e., gain should be recognized as cash (and other property with respect to which gain is recognized) is received." Senate Committee on Finance, 96th Cong., 2d Sess., Installment Sales Revision Act, Section H, (Comm. Print Sept. 26, 1980) [hereinafter 1980 Act].

It is clear that of the $[redacted] gain on the sale of the property, some portion must be taken in [redacted], when the $[redacted] cash was paid, and some portion must be included in [redacted], when the $[redacted] in notes come due. The issue is the $[redacted] exchange credit. A portion of the exchange credit, $[redacted], was exchanged in [redacted] for like-kind property, while the remaining portion was satisfied in cash. The issue is in what year is the $[redacted] cash received recognized, [redacted] or [redacted].

As noted in your request, the Ninth Circuit in Starker v. United States, 602 F.2d 1341, 1356 (9th Cir. 1979), aff'g in part and rev'g in part 432 F. Supp. 864 (D Ore. 1977), determined that nonqualifying section 1031 property received in a section 1031 transaction and which was intended to be section 1031 property should be included in income for the year of sale, not in the year of receipt.

On May 31, 1967, T. J. Starker and his son and daughter-in-law deeded timber land to Crown Zellerbach (Crown). Crown gave the Starkers "exchange value credits" equal to the fair market value of property conveyed. In accord with their agreement, Crown was committed to acquire and deed to the Starkers other realty that would be located by the Starkers. If at the end of five years, an exchange balance in favor of the Starkers still existed, Crown could pay the amount of this balance in cash. The Starkers could not demand payment in cash prior to the end of the fifth year.

Within four months, the son and daughter-in-law found suitable land, and Crown purchased and conveyed them pursuant to the agreement. In their income tax returns for 1967, the three Starkers all reported no gain on the transactions. They claimed that the transactions were entitled to nonrecognition treatment.

The Service disagreed, and assessed deficiencies. The deficiencies were paid, claims for refund were filed and denied, then actions for refund were filed in District Court. In the son and daughter-in-law case, the district court concluded that the nonrecognition provisions of section 1031 applied even though the transfers did not occur simultaneously. Starker v. United States, 75-1 USTC ¶ 9443 (D. Ore. 1975). The Government dismissed its appeal of the decision.

T. J. Starker, the father, received nine parcels of like-kind property. In addition, two properties were conveyed by Crown to Starker's daughter at his request. One such property was a residence occupied by Starker, and the other was a commercial building. The one remaining conveyance to Starker was a third parties' contract right to purchase a commercial parcel.

Two years after the decision concerning Bruce Starker, the same district court judge heard the case of T. J. Starker. The judge concluded that he was mistaken in the earlier decision. Without deciding that only simultaneous exchanges qualify for nonrecognition, he held that the transfers of the nine parcels were ineligible for like-kind treatment. His rationale was that Starker received a promise to convey like-kind property in the future, a transaction outside the purview of section 1031. T. J. Starker appealed the district court decision.

With respect to the nine properties, the Ninth Circuit held that the doctrine of collateral estoppel foreclosed the Government from litigating the question of whether the chance that Starker would receive cash prohibited him from qualifying for like-kind treatment. It concluded that the two properties deeded to the daughter triggered the recognition of gain because the taxpayer did not become their owner. Moreover, the residential property was not held for investment. In the court's opinion the contract right assigned T. J. Starker to purchase the remaining parcel was eligible for nonrecognition.

With respect to the two properties which triggered the recognition of gain (which were received sometime in 1968 and 1969), the court then decided the timing of inclusion. The court concluded that the proper result was to treat them both as received in the year of original exchange and agreement with Crown, 1967. The court then noted the result "leaves the treatment of an alleged exchange open until the eventual receipt of consideration" which could cause "administrative difficulties." Starker, 602 F.2d at 1356.

Accordingly, under the Starker decision, the $[redacted] in exchange credits received in cash would be reported for tax purposes in [redacted].

Section 1031 was amended in 1984 by the addition of section 1031(a)(3), which specifically addresses the problem in Starker. See Joint Explanatory Statement of the Committee of Conference, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, Section E (Comm. Print June 23, 1984) [hereinafter 1984 Act]. Section 1031(a)(3) provides that nonrecognition is available if, and only if, after property has been relinquished by the taxpayer, the like-kind property is identified within 45 days and is received within the earlier of 180 days or the due date of the taxpayer's return. Section 1031(a)(3) is effective for transactions entered into after July 18, 1984, in tax years ending after such date.

The transaction in the instant case falls after Starker (1979) and before the effective date of Public Law 98-369 (1984). [redacted], O.M. 19757, I-244-83 (Nov. 4, 1983), supports Starker for cases occurring before the Installment Sales Revision Act of 1980 (1980 Act). The window remaining between the effective date of the 1980 Act, October 20, 1980, and the 1984 Act, July of 1984, is the issue. Does the Starker analysis hold, or the implication of O.M. 19757 that the 1980 Act alters Starker? We believe that the 1980 Act modified Starker such that boot is recognized in the year received, not in the year of the original transaction.

In O.M. 19757, in a discussion of [redacted], it was concluded that for purpose of calculating gain, the year of inclusion was the year the property was conveyed, not the subsequent year boot was received. However, the result hinged on the fact that the transaction was not governed by section 453, as revised by Public Law 96-471.

On [redacted], [redacted] (seller) conveyed [redacted] parcels of land to [redacted] (buyer). The trust created by seller and buyer eventually conveyed the following exchange properties by the trust to the seller: [redacted], [redacted] properties were conveyed by the trust to the seller; [redacted], [redacted] properties were conveyed by the trust to the seller; [redacted], a [redacted]% undivided interest in [redacted] properties were conveyed by the trust to the seller; on the same date the [redacted]% undivided interest in the [redacted] properties was conveyed by the seller to a limited partnership; [redacted], cash remaining in the trust of $[redacted] was distributed to the seller. At this point the transaction was complete. The [redacted]% undivided interest in the [redacted] properties conveyed by the seller to the limited partnership was determined to be taxable boot from the exchange.

In determining the year that the cash and the not like-kind property were to be included in income, the O.M. noted the "only existing contingency was whether the agreed upon price would in the final analysis, be paid in property or cash." O.M. 19757 at 9. After noting the year of sale, [redacted], was an open year, the O.M. "suggest[ed] Starker be followed for purposes of determining the year income is recognized." Id. at 9. However, the conclusion seemed to rely in great part on the fact that the transfer of property took place before section 453(f)(6) was added to the Code.

> Since the taxpayer transferred its property prior to the effective date of the Installment Sales Revision Act of 1980, P.L. 96-471, which amended I.R.C. § 453, our conclusion is that to the extent [redacted] has recognized gain from the non-like-kind property and cash received in the transaction, it should be recognized in the year of sale.

Id. at 9 (emphasis added).

In an earlier case, the Tax Court held that the year of recognition of gain was the year of the receipt of boot, a year subsequent to the year of the taxpayer's transfer of property. J. H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962). In Baird, a Sunday school board was interested in acquiring property from Baird, which had indicated that it would be interested in an exchange only. A real estate broker was used as a third party and in October 1956, purchased an unimproved lot in accord with an exchange agreement with Baird requiring the broker to locate acceptable real property and make specific improvements. A few days later, Baird deeded its property to the broker, but retained a right of rent-free occupancy until the broker completed construction on the replacement property. The broker deeded the Baird property to the Sunday school board. The broker deposited cash into a bank account in the name of the broker as escrow agent for Baird.

In July 1957, the taxpayer surrendered its rent-free occupancy in exchange for title to the replacement property plus additional cash consideration to even out the exchange. Thus, there was a lapse of almost nine months between the initial transfer of title by the taxpayer and its receipt of replacement property and cash boot. The Tax Court avoided the simultaneity-of-transfer issue by characterizing the October 1956 transfer as "but one of the steps in an integrated transaction which contemplated an exchange of properties like-kind." Baird, 39 T.C. at 618. The October 1956 conveyance transferred only legal title, while Baird retained the beneficial ownership of the property, the Tax Court ruled. "This characterization of the rent-free occupancy as 'beneficial ownership' preserved reciprocity in the transaction and supported the court's finding that the entire exchange occurred in the July 1957 transaction, rather than in a transaction beginning in October 1956, and ending in July 1957." Note, Nonsimultaneous Like-Kind Exchanges, 56 Texas Law Review 1271, 1285 (1978). The court's tortured construction of the transaction does not necessarily conflict with Starker, in that the Baird court ruled the transaction did not occur until 1957, the year boot was recognized. Nonetheless, the result of Baird was recognition of boot in a year subsequent to a transfer of property.

Relying on the implied holding of O.M. 19757, and on the reality of the transaction in Baird, we believe that the $[redacted] cash received on the exchange credit should be recognized in the year of its receipt, [redacted], not in the year property was transferred, [redacted]. We believe the result in Starker was effectively altered by the Installment Sales Revision Act. Because the years at issue in the instant case fall after the 1980 Act, the question of the timing of the recognition of gain when boot is received should fulfill "the basic purpose of installment sale reporting, i.e., gain should be recognized as cash ... is received." Committee Report on 1980 Act, Section H (emphasis supplied).

Using the models included in your request, we feel the proper treatment is Theory Two. The gain portion of the $[redacted] cash received in [redacted] is recognized in [redacted]; the gain portion of the $[redacted] notes due in [redacted] is recognized in [redacted]. Likewise the gain portion of the exchange credit, $[redacted] of the $[redacted] credit, is similarly recognized when it is received, in [redacted].

The Ninth Circuit in Starker was aware that recognition of boot in the year the contract is made "leaves the treatment of an alleged exchange open until the eventual receipt of consideration by the taxpayer." Starker, 602 F.2d at 1356. The resulting "administrative difficulties" were for Congress to sort out. Indeed, Section 1031(a)(3) of the 1984 Act did eliminate these difficulties. However, for the years prior to the 1984 Act, these difficulties are present. While the administrative difficulties are not paramount in the instant case, as the years [redacted] and [redacted] are open, the result that boot is recognized in the year of receipt alleviates this problem.

Additionally, the conclusion seems supported by the Committee Report on the 1980 Act referring to like-kind exchanges, which emphasized the purpose of installment sales, to tax gain in the year cash is received. This language presumably affected O.M. 19757's conclusion to follow Starker because the property was transferred prior to the enactment of the 1980 Act. Our result also removes the administrative difficulties resulting from the Starker holding. "The effect of the application of § 453 to cases like Starker is that if cash (rather than like-kind property) is ultimately received, gain is recognized in the year of such receipt, not (as the court in Starker ruled) for the year in which the taxpayer's property was relinquished." W. Klein, B. Bittker, L. Stone, Federal Income Taxation 341 (7th Ed. 1987).

Gross Profit Percentage

Prior to the enactment of section 453(f)(6) of the Internal Revenue Code by the Installment Sales Revision Act of 1980, Rev. Rul. 65-155, 1965-1 C.B. 356, provided guidance regarding the interplay of sections 453 and 1031. Rev. Rul. 65-155 illustrates that the gross profit is the gain to be recognized under section 1031(b). Rev. Rul. 65-155 also illustrates that payment included the receipt of like-kind property received under section 1031(b).

Congress enacted section 453(f)(6) under the Installment Sales Revision Act of 1980 because it believed that payment under the installment method should not include like-kind property. *Under section 453(f)(6) of the Code, when an* exchange under section 1031(b) occurs, the total contract price must be reduced to take into account the amount of any property permitted to be received in such exchange without recognition of gain. Moreover, the gross profit from such exchange must be reduced to take into account any amount not recognized by reason of section 1031(b). Finally, the term "payment" will not include any property permitted to be received in such exchange without recognition of gain. See section 15A.453-1(b)(2) and (3) of the temporary Income Tax Regulations for definitions such as total contract price, gross profit, and payment as they relate to typical installment sales.

Pursuant to section 453(f)(6) of the Code, the installment method is applied to the taxpayers' installment sale as follows. In [redacted], the taxpayers must recognize the $[redacted] cash payment. Of the $[redacted] recognized, the taxpayers must include in gross income [redacted] percent or $[redacted]. The gross profit ratio of [redacted] percent is determined from the following information by assuming that the taxpayers will receive $[redacted] in like-kind property for the exchange credit. The total contract price in the year the transaction occurred is $[redacted] ($[redacted] less $[redacted] of property permitted to be received in the exchange without recognition pursuant to section 453(f)(6)(A)). The gross profit is $[redacted] ($[redacted] selling price less $[redacted] adjusted basis less $0 of nonrecognized gain under section 1031(b) pursuant to section 453(f)(6)(B)). The gross profit ratio of [redacted] percent results from the $[redacted] gross profit to be realized being divided by the $[redacted] total contract price.

In [redacted], however, the gross profit ratio must be recomputed because the taxpayer receives $[redacted] in like-kind property and $[redacted] in cash for the exchange credit. Rev. Rul. 72-570, 1972-2 C.B. 241, provides that modification of an installment obligation by reducing the original sales price is not a disposition or satisfaction of the installment obligation. See also Rev. Rul. 55-429, 1955-2 C.B. 252, and Rev. Rul. 68-419, 1968-2 C.B. 196. Rev. Rul. 72-570 holds that such an installment obligation's gross profit may be recomputed as of the date of the modification. The gross profit is recomputed by using the adjusted sales price, subtracting the total amount of profit already reported, and spreading the remaining unreported gross profit evenly over the remaining installments. Similarly, changing the form of property given for the exchange credit is not a disposition of the installment obligation. The change, however, is a modification requiring the same adjustments to the gross profit made under Rev. Rul. 72-570.

Accordingly, in [redacted], the taxpayers must recognize only the $[redacted] cash payment. The $[redacted] of like-kind real property is not treated as payment under section 453(f)(6)(C) of the Code and has a basis of $[redacted] under section 1031(d). Of the

$[redacted] recognized, the taxpayers must include in gross income [redacted] percent or $[redacted]. The gross profit ratio is redetermined from the following information pursuant to Rev. Rul. 72-570. The recomputed total contract price is $[redacted] ($[redacted] less the $[redacted] of cash already received in [redacted] less $[redacted] of property permitted to be received in the exchange without recognition of gain pursuant to section 453(f)(6)(A)). The recomputed gross profit is $[redacted] ($[redacted] less $[redacted] of total profit already reported in [redacted]). The recomputed gross profit ratio of [redacted] percent results from the $[redacted] gross profit to be realized being divided by the $[redacted] total contract price.

In [redacted], the taxpayers must recognize the $[redacted] payments received under the notes. Of the $[redacted] recognized, the taxpayers must include in gross income [redacted] percent or $[redacted]. The gross profit ratio is identical to the gross profit ratio redetermined for [redacted]. Accordingly, the taxpayers total gain recognition is $[redacted] ($[redacted] in [redacted], $[redacted] in [redacted], and $[redacted] in [redacted]).

Because our conclusion applies for only the tax years [redacted] through [redacted], its impact should not be substantial on revenue collection. Because the area is open to interpretation and our conclusion results in a favorable response to the taxpayers, the litigation hazards are minimal.

If you have any questions, please call Martin Osborne at FTS 566-3521.

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